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Address by

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"Current Perspectives on Monetary Policy"

It is a pleasure for me to address this sixth Annual Monetary Conference of the Cato Institute. The focus of the conference--on deficits and trade as well as on consequences and rules of alternative exchange rate regimes--is important and certainly timely.

The title of my talk listed in your program is "Current Perspectives on Monetary Policy." One way of addressing this topic would be to discuss the specifics of the Federal Reserve's current concerns and goals for policy in 1988. However, Chairman Greenspan has addressed these points at the Humphrey-Hawkins hearing before Congress just this week and I see no need to repeat his statement.

Instead, what I would like to talk about today relates to the more fundamental long-term goals of monetary policy and how we can proceed to reach these goals--particularly under current domestic and international monetary arrangements.

Clarifying the goals of policy is especially important in our current monetary environment in which essentially every currency in the world is directly, or indirectly, on a pure fiat standard.

We have learned a great deal about the appropriate goals of monetary policy in recent years. We know, for example, that under fiat arrangements, price stability is an achievable goal and should be a principal objective. A policy that fosters steadiness and predictability in the general price level is essential for genuine non-inflationary economic growth.

We have also learned that sharp unanticipated changes in monetary policy can be disruptive to the economy. Accordingly, the pursuit of price stability should also seek to minimize such short-term disruptions to economic activity.

Among monetary experts, there probably is little disagreement on these policy goals. However, there is currently a good deal of disagreement on how to best achieve these objectives.

Until a few years ago, there was a growing consensus among monetary economists that the best way to conduct policy was to target monetary aggregates as an intermediate objective. It appeared that the quantity of money was a superior target for the Fed to use in order to achieve price stability and to promote stable economic activity.

Unfortunately, in recent years it has become evident that the relationship between the monetary aggregates and income has become less predictable. Various measures of the velocity of money, for example, have experienced large deviations from trend during the 1980's. Indeed, over this period the decline in velocity for most monetary aggregates has been unprecedented in the post-war era. And, as yet, this decline is not fully understood. Consequently, future movements in velocity remain uncertain.

There are several factors that have contributed to this deterioration in performance of the monetary aggregates. While it is probably premature to draw any definite conclusions, it appears that the interaction of deregulation, disinflation, and sizable movements in interest rates have worked to alter the behavior of money supply measures. Due to these factors, money growth is much more sensitive to changes in interest rates and opportunity costs than was previously the case. Since this increased sensitivity works to lessen the predictability of the relationship between money and GNP, these aggregates become less reliable as policy targets.

Admittedly, it is probably too early to conclude that the monetary aggregates will not be useful in the future as policy indicators or targets. But even if stable, predictable velocity re-emerges, it will take an extended period before enough confidence and credibility can be mustered so that money supply measures can be used as the sole intermediate target of policy.

Given this (at least temporary) deterioration in the performance of the monetary aggregates, what alternative indicators are available for implementing policy? Also, what properties should they possess?

First, useful indicators should be accurately measurable and readily available. Second, they should respond to changes in Federal Reserve policy actions. And third, they should be reliably related to the ultimate goals of monetary policy.

Given these guidelines, there has been some interest recently in the use of nominal prices of certain financial instruments traded in auction markets as indicators for policy. More specifically, information contained in the term structure of interest rates (yield curve), the foreign exchange market, and certain broad indices of commodity prices has proven useful in the formulation of monetary policy.

Other things equal, all of these indicators should provide signals as to when monetary policy becomes expansionary (easy) or restrictive (tight). For example, should one observe the simultaneous occurrence of a steepening yield curve, increasing commodity prices, and a depreciating dollar, then it may be inferred that monetary policy most likely has been expansionary.

However, this approach certainly is not foolproof and when such indicators are followed in isolation they can sometimes prove to be misleading. Also, they are not always independent from each other and can be affected by expectations of policy change.

Yet despite these caveats, preliminary evidence is promising enough to suggest that these indicators may prove useful in the formulation of policy. If nothing else, they provide useful information that should not be ignored.

The use of market determined prices as policy indicators (or informational supplements) is an appealing strategy for several reasons. First, the data measuring these variables are readily available, literally by the minute. These market prices provide observable, timely, and more accurate information than is provided by other sources. There are no problems with revisions, seasonal adjustment procedures, or shift adjustment corrections that plague quantity or volume data. And the strategy does not rely on unobservable variables such as real interest rates that depend on accurate measurements of future price expectations.

Second, the strategy is premised on the notion that market prices encompass the knowledge and expectations of a large number of buyers and sellers. And while it is true that individual market participants may be irrational, this is not likely to be the case for the market as a whole. Therefore, these prices, reflect the consensus of opinion about the current and expected future values of these financial instruments. As such, they serve as communicators of changing knowledge of market conditions.

Third, since there is evidence that the broader price measures such as the CPI or GNP deflator are slow to reflect new information, changes in monetary policy should be reflected in these financial auction market prices well before they affect the broader price measures. Thus, there is reason to believe they may give advance warning of impending change for important concerns such as inflation.

It is worth noting that monitoring financial markets in conjunction with one another to piece together a consistent interpretation is not novel. During the period when England had gone off the gold standard in the early nineteenth century, for example, Classical monetary writers monitored such indicators to assess central Bank policy. There is a passage in the famous Bullion Report published in 1810 in which this is clearly documented. Because financial innovations had occurred and accurate and timely monetary statistics were not available at the time, these monetary analysts argued that the Central Bank should use financial market prices as guides to policy.

In the time remaining I cannot possibly give you a detailed analysis of all the research pertaining to the yield curve, the foreign exchange rate, or commodity prices. Nor can I provide any simple prescription on how these indicators should be interpreted. Suffice it to say that there are some difficulties associated with each of these indicators as separate forecasting tools. But when examined together, they often yield valuable insights in evaluating the stance of monetary policy and particularly in assessing movements in expectations of inflation.

The Yield Curve

With respect to money and bond markets, empirical evidence suggests that expansionary monetary policy is often reflected in a more positively sloped yield curve whereas a yield curve that becomes inverted (negatively sloped) often reflects a restrictive policy stance. Inverted yield curves, for example, have preceded most recessions in the post-war era. Indeed, the results of one recent study indicated that the spread between the Fed funds rate and the long bond rate outperformed three other important variables as an indicator of the impact of monetary policy on future real economic activity.

Most analysts do believe that there is useful information reflected in the yield curve. And there are theoretical reasons and evidence to suggest that this spread reflects expectations of future yields as determined in part by expectations of future inflation. These observations imply, of course, that it is not the level of interest rates but the spread that may serve as a useful indicator of the stance of monetary policy.

But one cannot perfectly predict the affects that a change in policy will have on the yield curve; hence this indicator should not serve as a single target of policy. The yield curve is affected by a number of other factors such as, changes in Treasury funding policy, altered risk premiums, tax policy, as well as changes in liquidity preference.

Commodity Prices

There is also, some empirical evidence to suggest that broad indices of commodity prices respond to changes in monetary policy and tend to lead changes in broader measures of inflation.

The reliability as well as the quantitative importance of these empirical relationships, however, have not been firmly established. And little evidence exists that indicates the Fed can accurately control such indices. Moreover, commodity prices are volatile and are influenced by a number of factors not related to monetary policy. Accordingly, commodity prices are probably more valuable as an indicator of monetary policy than as a target.

The Foreign Exchange Value of the Dollar

It has long been recognized that the foreign exchange value of the dollar can also provide useful information for monetary policymakers. The exchange rate often indicates the stance of U.S. monetary policy *relative* to that in other countries, and therefore offers a gauge of <u>relative</u> monetary expansion or contraction.

For example, if the dollar is depreciating while the yield curve is steepening and commodity prices are rising, policy is likely expansionary and perhaps overly so.

On the other hand, if the dollar is depreciating while commodity prices and the yield curve are stable, the dollar may reflect restrictive foreign monetary policy or other external factors.

Moreover, if the dollar was declining and the yield curve was steepening but commodity prices remained stable, this could reflect an outflow of foreign funds from the U.S. bond market for reasons other than inflationary expectations.

Monitoring exchange rate movements to supplement other indicators, of course, is not foolproof. The exchange markets are volatile and intervention can (at least temporarily) distort signals from this market. Morever a great deal of information about foreign economic performance and policy is required to properly assess this market.

It should also be pointed out that exercises in international coordination of monetary policy--which necessarily implies a move to more stable exchange rates--suggests that the information content of foreign exchange rates is lessened. While stable exchange rates are desirable, stability removes information from this market. After all, it is (theoretically) possible to have either rapid inflation or rapid deflation with stable exchange rates.

Accordingly, information provided by commodity prices and yield curves may assume more importance in analyzing inflationary expectations should coordination be used to stabilize exchange rates.

Summary

To sum up, in spite of several caveats and in the absence of reliable alternative indicators, financial auction markets can provide useful information to the process of monetary policy formulation. I believe the strategy outlined here provides a framework for focusing monetary policy on the conditions for price stability. And price stability is a goal that should direct our attention to these markets.

Thank you.